DEVELOPMENT OF THE DISCOUNT CATEGORY

MANUFACTURERS' INITIAL DISCOUNT ENTRIES (Share based on MSA Data)

June 1980 - Liggett created the discount category by introducing generic products with nondescript packaging and priced approximately $1.00 per carton lower than the current retail price of full margin brands. Liggett remained the only manufacturer of discount products for the next three years exhibiting moderately steady growth and reaching a monthly discount market share level of 2.4 in May 1983.

July 1983 - RJR and **B&W** were the next manufacturers to enter the discount category with the introduction of Century 25's and Richland 25's respectively. These products were positioned to offer more value for the money by providing twenty-five cigarettes for the price of twenty.

May 1985 - PM-USA introduced its first discount product, Players Lights 25's. At this time, the discount category had reached a total market share of 6.6 and RJR was aggressively expanding its presence within the segment.

January 1987 - American was the next manufacturer to enter the discount segment with the introduction of Malibu. By this time the category's market share had grown to 11.6.

October 1989 - Lorillard was the last manufacturer to enter the discount segment with the limited introduction of Heritage.

DISCOUNT CATEGORY MILESTONE DATES

June 1980 - Discount category created by **Liggett** with the introduction of generics.

June 1984 - Branded generic category created by **RJR** with the introduction of Doral.

January 1989 - Sub-generic category created by **Liggett** with the introduction of Pyramid.

May 1990 - Deep discount category created by **American** with the introduction of Private Stock.

DISCOUNT CATEGORY PHASE 1 (1980 - 1988)

Liggett created the discount category as a matter of survival. Given the company's position in the industry, brand lineup and insufficient resources to build brand equity, price became the only marketing element with which they could compete for volume. Reflecting Liggett's weak position, their strategy of being first with discount was an attempt to gain as much share as possible before the inevitable competitive response.

Although **Liggett introduced their generic products nationwide**, early growth occurred primarily in the Mid-Western, South Western and Western Regions. Initial distribution efforts focused on Supermarkets and other high volume carton outlets frequented by value conscious shoppers. Discount category growth gained momentum when Liggett decided to absorb a majority of the FET increase in January 1983, thereby widening the price differential.

The initial growth of discount had the most **immediate impact on RJR and B&W** because of the demographics of their smokers. The competitive response of these companies was to introduce 25's packings in an attempt to desensitize price and provide added value to the customer.

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B&W was next in the generic segment, introducing GPC in direct price competition with Liggett for both trade customers and consumers. In fact, Liggett sued B&W for predatory pricing they felt was intended to drive them out of business.

By December 1983, the total number of discount packings from Liggett, RJR and B&W had grown to 16.

RJR, however, noted significant volume and share growth potential from the growing discount category which could possibly arrest their total company declines and perhaps result in net gains. They decided to use price as a unique selling proposition for a branded product and **established Doral as the first branded generic**. These products were priced the same as generics with a price differential of 40% to premium products.

By the end of April 1985, RJR's total discount market share (based on MSA) had reached 1.7 representing 23.6 share of the discount category. At the same time, B&W's total discount market share had grown to 1.1 resulting in a 15.0 share of category. Meanwhile, Liggett's total discount share began to reflect these competitive initiatives and fell to 4.3, down from its all time high of 6.0 in January 1985.

In December 1985, **RJR assumed leadership of the discount category** with a 30.9 monthly MSA share of category followed by Liggett at 30.3, B&W at 28.7 and PM with 10.1. At the end of 1985, the total number of discount packings had increased to 41.

PM-USA's position during the early development of discount was to not participate in or legitimize the category in the hope it would disappear. However, once Doral was launched and began to acquire the characteristics of a legitimate brand at a lower price, **PM-USA introduced Cambridge and FVB in mid 1986.** By December 1986, Doral and Cambridge had attained retail distribution levels of 81% and 68% respectively and a total of 81 discount packings from four manufacturers were available.

By the end of 1986, total MSA market share of discount had reached 8.9 with RJR, B&W, Liggett and PM achieving share levels within the discount category of 40.0, 27.5, 20.2 and 12.3 respectively. In addition, market share of branded generics had clearly surpassed 25's and was at parity with black and white generics.

Branded generics became the leading discount subsegment in mid 1987 driving total discount MSA market share to 11.3 at year end. By then, distribution levels of Doral and Cambridge had grown to 87% and 79% respectively.

American's late entry into the discount category (1987) was somewhat surprising given the weakness of their brands and smoker demographics. In an effort to recover from their slow start, American became a primary player in the discount category's next development cycle by introducing several new sub-generic brands in multiple packings.

DISCOUNT CATEGORY PHASE 2 (1989 - Mid 1991)

Liggett's strategic response to the erosion of their discount share was to avoid head-to-head competition with the industry leaders and recreate their success of gaining share and volume at the lowest price point by **introducing a new price tier, sub-generics.** Pyramid was launched in January 1989 at a price differential of 39% to branded generics and 56% to premium products.

Also in January 1989, **B&W repositioned Viceroy** from the full margin category to the branded generic segment and **PM-USA repositioned Alpine** as the first free standing menthol branded generic product. This was an attempt to increase relevant product value by leveraging brand equity with low price.

The introduction of **sub-generics provided American with an opportunity** to participate on an equal basis in the creation of a new discount segment. Brands such as Montclair (1989) and Misty (1990) were quickly introduced and soon gained distribution and share, mostly at the expense of RJR. During this cycle, American's share of the discount category grew 6.3 share points.

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PM-USA responded to the creation of sub-generics by launching Bristol in late 1989. During this cycle, PM's discount strategy of passive participation was replaced with a discount growth objective. **American** created a new price tier, **deep discount**, in May 1990. In response, PM introduced twelve deep discount products in October 1990. PM's share of the discount category surpassed RJR in March 1991 and grew a total of 4.6 points during this cycle.

RJR's strategic response to sub-generics was to compete in the segment with Doral. This action met with limited success and in May 1991, Magna and Sterling were repositioned as sub-generics to protect Doral and extend RJR's product lineup. RJR, however, lost a total of 8.9 share points within the discount category during this cycle.

Lorillard launched Style in mid 1991, however their minimal support reflects a strategy of investment and focus in premium brands. Given their limited resources and product lineup, Lorillard has sought to selectively participate in discount market niches.

DISCOUNT CATEGORY PHASE 3 (Mid 1991 - Mid 1992)

The next evolution in discount began in mid 1991 when a series of **pricing actions raised sub-generic prices faster than premium thus reducing the gap.** From mid 1991 to mid 1992, the price differential between these segments had fallen 7.2 points to 31%. As a result, the growth of sub-generics was disrupted and the segment's market share flattened at about 6.5 share points, rising to 7.6 in December 1991 before eroding to 6.8 in mid 1992.

However, **price increases for deep discount products during this time could not be sustained.** Premium price increases continued and the differential between these products and premium widened from 48% in mid 1991 to 52% by mid 1992. During this cycle, market share of the deep discount segment grew 6.4 points.

Although PM-USA, RJR and B&W gained discount market share during this cycle, a clear market leader was never established with less than 1.0 share point separating PM and RJR. This situation led to instability as the opportunity to gain a long term marketing position may have influenced short term marketing decisions.

DISCOUNT CATEGORY PHASE 4 (Mid 1992 - Mid 1993)

In mid 1992, discount began another transformation with the **resurgence of deep discount** at the lowest price tier. Consumer acceptance of these products increased as deep discount's use of brand type packaging and greater number of packings combined with record distribution levels across all trade classes. Premium price increases coupled with deep discount's resistance to raising prices have widened the price gap resulting in unprecedented growth for deep discount.

During this cycle, the **discount category growth averaged 1.0 share point per month** driven by gains in **deep discount which averaged growth of 1.5 share points per month.**

As a strategy to regain discount leadership, **RJR launched Monarch** at the lowest price point and **repositioned Doral as a sub-generic,** providing both efforts with generous marketing support. As a result, RJR has emerged as the clear discount category leader compared to PM-USA.

This recent period of a clear market order may have influenced the industry's acceptance of two deep discount price increases announced in October and November. However, RJR announced that their deep discount prices would not be raised to include the 1993 FET increase. This action may indicate that RJR is protecting its position and does not want to provide any opportunity for market instability at the low end.

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DISCOUNT CATEGORY PHASE 5 (Mid 1993 -)

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DISCOUNT CATEGORY PRICING ACTIONS

From 1980 to 1983, **Liggett's** discount products maintained a $1.00 per carton differential versus premium retail prices. However, in January 1983, Liggett absorbed a majority of the FET increase, more than doubling the differential.

RJR and **B&W** responded in mid 1983 by offering 25's packings which were priced slightly higher than generics but provided greater "value" with more cigarettes. With the introduction of Doral in mid 1984, **RJR** created a new segment known as **branded generics** priced the same as generics with a differential of 40% to premium products. In June 1987, PM raised the price of branded generics by $0.25/M over generics, but by June 1988 prices of the two segments were at parity with a differential of 29% to premium products.

Liggett created the sub-generic tier in January 1989 by offering Pyramid at a discount of $2.50 per carton below branded generics (39% differential) and $4.88 per carton less than premium brands (56% differential).

In May 1989, Doral and Magna limited their price increases to half the branded segment's $2.50/M increase. However, these brands did raise prices to match the new branded segment levels during the November 1989 pricing action.

Within the sub-generic segment, Bristol did not raise prices in November 1989 and stayed $1.25/M below other sub-generics. Bristol also did not participate in the May 1990 price increase and extended its price advantage to $2.75/M.

In October, Bristol did raise prices $2.75/M to match the current sub-generic price levels and went up an additional $2.50/M during the next pricing action in November 1990 resulting in a price differential of 50% to premium.

May 1990 marked **American's introduction of a deep discount** segment which had price differentials with premium, branded generic and sub-generics of 63%, 51% and 22% respectively.

After the 1991 $2.00/M FET increase, on which manufacturers added $0.10/M, B&W attempted to raise premium prices in March by $2.50/M but the industry settled for $0.75/M. By year end, deep discount had price differentials with premium, branded generic and sub-generics of 48%, 41% and 21% respectively.

In April and June 1992, PM-USA failed to sustain price increases in the deep discount segment and in August the branded generic segment was collapsed into sub-generics establishing a new segment, branded discount. At this time, deep discount had price differentials with premium and branded discount of 60% and 43% respectively.

Deep discount prices were raised a total of $4.00/M in October and November 1992 and now have price differentials with premium and branded discount of 56% and 38% respectively. American tried but failed to hold this pricing.

SOME OBSERVATIONS

The emergence of discount as a viable category has developed in a similar manner to other significant revolutions within the industry such as filters, menthol and low tar. In particular, the dramatic resurgence of deep discount represents this type of change taking place within a change.

Unlike these previous examples of change in which consumer demand drove growth, manufacturers have significantly influenced discount by consistently raising premium prices in excess of economic measures. These higher prices have influenced consumer behavior in two ways; First, at what price threshold do consumers balk? Second, at what price differential do consumers trade down to increase value?

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From 1980 through 1988, the battle for discount share was extended from the low price only proposition to include brand marketing elements such as POS, multiple packings, promotions, improved packaging, advertising and wide distribution. In 1989, this phenomenon was repeated when sub-generics were introduced at a lower price point and manufacturers redirected marketing spending to support the new tier. It appears this cycle is reoccurring again in 1992 with the development of branded products such as Monarch and Raleigh Extra at the deep discount price point.

Since attaining market share leadership within the discount category in late 1985, RJR vigorously solidified its position. From January 1989 through August 1990, RJR maintained a total discount market share advantage over PM-USA of about 1.5 share points. However, RJR's lead over PM-USA within the discount category narrowed from 12.2 to 8.0 share points primarily due to American's discount push. This period of relative stability was disrupted when PM-USA aggressively began pursuing discount share in September 1990, closed the gap and surpassed RJR as the category leader in March 1991.

NIELSEN DISCOUNT:

	JAN 1989		AUG 1990		MAR 1991	
Company	Share	SOC	Share	SOC	Share	SOC
RJR	4.7	37.1	6.3	32.5	6.6	28.2
PM-USA	3.2	24.9	4.8	24.5	6.7	28.8
AMERICAN	0.9	6.9	2.1	10.6	2.8	12.2

The relative quickness in which PM-USA closed the gap in discount market share and resulting lack of a clear category leader from mid 1991 to mid 1992 created instability. During this period, PM and RJR were never separated by more than 1.0 share point in discount. This close competition combined with the launch of Retail Masters may have caused RJR to interpret PM's actions as a lockout strategy.

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